Report

of the

Examination of

Germantown Mutual Insurance Company

Germantown, Wisconsin

As of December 31, 2004

TABLE OF CONTENTS

State of Wisconsin / OFFICE OF THE COMMISSIONER OF INSURANCE

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Jorge Gomez, *Commissioner*

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August 18, 2005

Honorable Jorge Gomez
Secretary, Midwestern Zone, NAIC
Commissioner of Insurance
State of Wisconsin
125 South Webster Street
Madison, Wisconsin 53702

Commissioner:

In accordance with your instructions, a compliance examination has been made of the affairs and financial condition of:

GERMANTOWN MUTUAL INSURANCE COMPANY
Germantown, Wisconsin

and this report is respectfully submitted.

I. INTRODUCTION

The previous examination of Germantown Mutual Insurance Company (Germantown or the company) was conducted in 2000 as of December 31, 1999. The current examination covered the intervening period ending December 31, 2004, and included a review of such 2005 transactions as deemed necessary to complete the examination.

The examination consisted of a review of all major phases of the company's operations and included the following areas:

History
Management and Control
Corporate Records
Conflict of Interest
Fidelity Bonds and Other Insurance
Employees' Welfare and Pension Plans
Territory and Plan of Operations
Growth of Company
Reinsurance
Financial Statements
Accounts and Records
Data Processing

Emphasis was placed on the audit of those areas of the company's operations accorded a high priority by the examiner-in-charge when planning the examination. Special attention was given to the action taken by the company to satisfy the recommendations and comments made in the previous examination report.

The section of this report titled "Summary of Examination Results" contains comments and elaboration on those areas where adverse findings were noted or where unusual situations existed. Comment on the remaining areas of the company's operations is contained in the examination work papers.

The company is annually audited by an independent public accounting firm as prescribed by s. Ins 50.05, Wis. Adm. Code. An integral part of this compliance examination was the review of the independent accountant's work papers. Based on the results of the review of these work papers, alternative or additional examination steps deemed necessary for the completion of this examination were performed. The examination work papers contain documentation with respect to the alternative or additional examination steps performed during the course of the examination.

Independent Actuary's Review

An independent actuarial firm was engaged under a contract with the Office of the Commissioner of Insurance. The actuary reviewed the adequacy of the company's loss and loss adjustment expense reserves. The actuary's results were reported to the examiner-in-charge. References are made in the "Summary of Current Examination Results" section of this report to the actuary's conclusion.

II. HISTORY AND PLAN OF OPERATION

The company was organized in 1854 as the state's first mutual insurance company. The company operated as a stock company from 1903 to 1906. In 1906 the company reverted to mutual company status. Germantown is a nonassessable, multiple-line property and casualty insurer.

In June 1999 the company completed its merger with Retail Lumbermen's Mutual Insurance Company of Wisconsin (Retail). From that merger the company obtained Retail's licenses in Michigan, Minnesota, and South Dakota, and acquired an agency. Since then the company sold the agency in 2000 and withdrew its license in South Dakota in 2003. In 2002 the company expanded to Utah to reduce its geographic concentration of property risks.

In 2004 the company wrote direct premium in the following states:

Wisconsin	$32,542,120	91.4%
Utah	2,671,381	7.1
Michigan	332,098	0.9
Minnesota	234,966	0.6
Total	$37,780,565	100.0%

The major products marketed by the company include homeowner's, farmowner's, commercial multi-peril, and personal and commercial automobile. The company also provides fire, allied lines, inland marine, lumber, worker's compensation and general liability coverage. Company products are marketed through 2,105 independent agents operating out of 383 agencies.

The following table is a summary of the net insurance premiums written by the company in 2004. The growth of the company is discussed in the "Financial Data" section of this report.

Line of Business	Direct Premium	Reinsurance Assumed	Reinsurance Ceded	Net Premium
Fire	$ 2,051,368	$	$ 329,846	$ 1,721,522
Allied lines	731,842		117,016	614,826
Farmowner's multiple peril	2,141,358		346,720	1,794,638
Homeowner's multiple peril	12,858,443		1,773,407	11,085,036
Commercial multiple peril	6,722,316		1,256,813	5,465,503
Inland marine	589,991		103,646	486,345
Worker's compensation	493,159		87,582	405,577
Other liability - occurrence	471,869		224,298	247,571
Private passenger auto liability	5,818,920		840,287	4,978,633
Commercial auto liability	24,915		384	24,531
Auto physical damage	5,876,384		191,715	5,684,669
Reinsurance - non-proportional assumed property		80,837		80,837
Reinsurance - non-proportional assumed liability		1,566		1,566
Total All Lines	$37,780,565	$82,403	$5,271,714	$32,591,254

III. MANAGEMENT AND CONTROL

Board of Directors

The board of directors consists of nine members. Three directors are elected annually to serve a three-year term. Officers are elected at the board's annual meeting. The board members currently receive a retainer fee of $700 with an additional $700 for each quarterly meeting attended. Board members also receive $350 for any special meetings attended.

Currently the board of directors consists of the following persons:

Name and Residence	Principal Occupation	Term Expires
Gene O. Arnold Germantown, WI	Owner, Goodyear tire store	2007
Roland W. Bast Richfield, WI	Owner, transportation company	2008
Patrick K. Byrnes Cedarburg, WI	Vice President, Dohnman Drugs	2008
G. Victor Herro Colgate, WI	Owner, accounting firm	2007
Jay L. Johnson Bonita Springs, FL	Retired funeral director	2006
Joel W. Kirsch West Bend, WI	Vice President, specialty printing company	2006
Ralph F. Patek Wauwatosa, WI	Retired investment advisor	2006
Richard R. Smith West Bend, WI	President/Treasurer of Germantown Mutual Insurance Company	2008
William H. Wetterau Richfield, WI	Owner, trucking company	2007

Officers of the Company

The officers serving at the time of this examination are as follows:

Name	Office	2004 Compensation
Richard R. Smith	President and Treasurer	$438,184
Don W. Sturm	Vice President, Commercial Underwriting	138,882
Les Ibach	Vice President & Controller	125,998
Arthur L. Hintz	Vice President, Personal Lines Underwriting	120,300
James R. Weninger	Vice President, Claims	106,176
Ronald R. Vermillion	Vice President, Marketing	92,577
Robert L. Viste	Assistant Vice President, Marketing and P. L. Underwriting	77,571

Compensation figures include base salaries, bonuses, pension, 401K and phantom stock options.

Committees of the Board

The company's bylaws allow for the formation of certain committees by the board of directors. The committees at the time of the examination are listed below:

Executive Committee
Richard R. Smith, Chair
Gene O. Arnold
G. Victor Herro

Audit Committee
G. Victor Herro, Chair
Gene O. Arnold
Joel W. Kirsch

Compensation Committee
Joel W. Kirsch, Chair
Patrick K. Byrnes
Richard R. Smith

Nominating Committee
Gene O. Arnold, Chair
G. Victor Herro
William H. Wetterau

IV. REINSURANCE

The company has several ceded reinsurance agreements in place through a reinsurance intermediary broker. The company's reinsurance portfolio and strategy is described below. A list of the companies that have a significant amount of reinsurance in force at the time of the examination follows. The contracts contained proper insolvency provisions.

The company also has ceded and assumed reinsurance agreements with an unincorporated reinsurance association named Mutual Reinsurance Bureau (MRB). MRB is composed of three member companies; each company automatically assumes one-third of risks, and the three companies are jointly liable. The current accepting mutual companies are listed below:

Member Company
Auto-Owners Insurance Company
Employers Mutual Casualty Company
Motorists Mutual Insurance Company

Nonaffiliated Ceding Contracts

1.	Type:	Property per risk excess of loss
	Reinsurer:	50% Mutual Reinsurance Bureau 25% Platinum Underwriters Reinsurance 25% SCOR Reinsurance Company
	Scope:	All property, excluding automobile
	Retention:	$125,000
	Coverage:	Section One $175,000 one risk $525,000 each occurrence $525,000 one or multiple acts of terrorism Section Two $700,000 one risk $1,400,000 each occurrence $1,400,000 one or multiple acts of terrorism
	Premium:	Section One – 6.0% of direct earned premium Section Two – 1.35% of direct earned premium Premium is due 45 days after the close of each month.

	Effective date:	January 1, 2005
	Termination:	Any December 31 with 60 days notice
2.	Type:	Casualty excess of loss
	Reinsurer:	50% Mutual Reinsurance Bureau 25% Platinum Underwriters Reinsurance 25% SCOR Reinsurance Company
	Scope:	All liability policies, including worker's compensation
	Retention:	$125,000
	Coverage:	<u>Section One</u> $175,000 one occurrence $600,000 one or multiple acts of terrorism <u>Section Two</u> $700,000 one occurrence $2,100,000 one or multiple acts of terrorism <u>Section Three</u> $1,000,000 one occurrence $1,000,000 one or multiple acts of terrorism
	Premium:	<u>Section One</u> – 9.0% of direct earned premium <u>Section Two</u> – 3.1% of direct earned premium <u>Section Three</u> – 1.0% of direct earned premium Premium is due 45 days after the close of each month.
	Effective date:	January 1, 2005
	Termination:	Any December 31 with 60 days notice
3.	Type:	Casualty excess of loss
	Reinsurer:	50% Mutual Reinsurance Bureau 25% Platinum Underwriters Reinsurance 25% SCOR Reinsurance Company
	Scope:	Worker's compensation and employer's liability
	Retention:	$2,000,000
	Coverage:	$2,000,000
	Premium:	6.5% of direct earned premium. Premium is due 45 days after the close of each month.
	Effective date:	January 1, 2005
	Termination:	Any December 31 with 60 days notice

4. Type: Property automatic facultative

Reinsurer: Mutual Reinsurance Bureau

Scope: All property

Retention: Various, as determined by the individual cessions of risk. The company cedes reinsurance on a pro rata basis dependent on the risks outlined in the contract.

Coverage: Up to $500,000 on any one risk

Premium: Pro-rata as determined by the individual cessions of risk. Premium is due 45 days after the close of each month.

Commissions: 30%

Effective date: January 1, 2005

Termination: Any December 31 with 60 days notice

5. Type: Personal umbrella

Reinsurer: Mutual Reinsurance Bureau

Scope: Personal umbrella, including farm

Retention: 5% of the first $1,000,000

Coverage: Section One – 95% of the first $1,000,000
Section Two – $1,000,000

Premium: Section One – 95% of premium for the first $1,000,000
Section Two – 100% of premium for next $1,000,000
Premium is due 60 days after the close of each month.

Commissions: 27.5%

Effective date: January 1, 2005

Termination: Anytime with 60 days notice

6. Type: Commercial umbrella

Reinsurer: Mutual Reinsurance Bureau

Scope: Commercial umbrella

Retention: 5% of the first $1,000,000

Coverage: Section One – 95% of the first $1,000,000
Section Two – $1,000,000

Premium: Section One – 95% of premium for first $1,000,000
Section Two – 100% of premium for next $1,000,000
Premium is due 60 days after the close of each month.

	Commissions:	25%
	Effective date:	January 1, 2005
	Termination:	Anytime with 60 days notice
7.	Type:	Facultative excess
	Reinsurer:	50% Wellington 50% Everest Reinsurance Company
	Scope:	Farm, commercial and lumber
	Retention:	Lumber - $300,000 Other - $500,000
	Coverage:	$2,000,000
	Premium:	Per rate table payable 45 days after end of the month.
	Effective date:	March 1, 2005
	Termination:	Anytime with 90 days notice
8.	Type:	First layer property catastrophe excess of loss
	Reinsurer:	Mutual Reinsurance Bureau
	Scope:	Catastrophe
	Retention:	$875,000 plus 2.5% of next $2,125,000
	Coverage:	97.5% of $2,125,000 one loss occurrence 97.5% of $4,250,000 in one year
	Premium:	2.85% of subject earned premium, subject to an annual minimum premium of $486,000 and a semi-annual deposit premium of $303,500 with reinstatement available
	Effective date:	January 1, 2005
	Termination:	Anytime by giving 90 days notice
9.	Type:	Second layer catastrophe excess of loss
	Reinsurer:	20% Platinum Underwriters Reinsurance 15% PXRE Reinsurance Ltd 15% Hannover Re (Bermuda) Ltd 10% QBE Reinsurance Corporation 10% Odyssey America Reinsurance Corporation 5% American Agricultural Insurance Company 5% Aspen Insurance Ltd 5% Lloyd’s Syndicate No. 2001 5% Lloyd’s Syndicate No. 2003 5% Lloyd’s Syndicate No. 2987 5% Lloyd’s Syndicate No. 4472

	Scope:	Catastrophe
	Retention:	$3,000,000
	Coverage:	$9,000,000 one occurrence $18,000,000 year
	Premium:	2.80% of subject earned premium, subject to an annual minimum premium of $468,000 and quarterly deposit premium of $146,250 with reinstatement available
	Effective date:	January 1, 2005
	Termination:	Any December 31 with 30 days notice
10.	Type:	Third layer catastrophe excess of loss
	Reinsurer:	Mutual Reinsurance Bureau
	Scope:	Catastrophe
	Retention:	$12,000,000
	Coverage:	$12,000,000 per one occurrence $24,000,000 per year
	Premium:	.77% of subject earned premium, subject to an annual minimum premium of $164,000 and a semi-annual deposit premium of $82,000 with reinstatement available
	Effective date:	January 1, 2005
	Termination:	Anytime by giving 90 days notice

Nonaffiliated Assuming Contracts

1.	Type:	Catastrophe pool
	Reinsured:	Mutual Reinsurance Bureau
	Scope:	Any and all aggregate and catastrophe contracts written under this catastrophe pool
	Retention:	Pro rata share of net retained liability
	Coverage:	1% of $7,500,000 any one occurrence or in the aggregate
	Premium:	1% of pool premium
	Commission:	7.5%
	Contingent commission:	15% of profit earned under agreement

	Effective date:	January 1, 2005
	Termination:	Any December 31 upon 90 days notice
2.	Type:	Regional reciprocal catastrophe pool
	Reinsured:	Mutual Reinsurance Bureau
	Scope:	Any and all aggregate and catastrophe contracts written under this regional reciprocal catastrophe pool
	Retention:	Various, as regard each pool participant. It is warranted that all contracts ceded to this agreement are top layers or portions of top layers within each respective program.
	Coverage:	1% of $20,000,000 in the aggregate
	Premium:	1% of pool premium less management fee of 10%
	Effective date:	January 1, 2005
	Termination:	Any December 31 upon 120 days notice

V. FINANCIAL DATA

The following financial statements reflect the financial condition of the company as reported to the Commissioner of Insurance in the December 31, 2004, annual statement. Also included in this section are schedules that reflect the growth of the company, NAIC Insurance Regulatory Information System (IRIS) ratio results for the period under examination, and the compulsory and security surplus calculation. Adjustments made as a result of the examination are noted at the end of this section in the area captioned "Reconciliation of Surplus per Examination."

Germantown Mutual Insurance Company
Assets
As of December 31, 2004

	Assets	Nonadmitted Assets	Net Admitted Assets
Bonds	$39,786,681	$	$39,786,681
Stocks:			
Common stocks	5,936,527		5,936,527
Mortgage loans on real estate:			
First liens	194,169		194,169
Real estate:			
Occupied by the company	1,892,720		1,892,720
Properties held for the production of income	679,255		679,255
Cash	286,606		286,606
Short-term investments	390,683		390,683
Other invested assets	184,000		184,000
Write-ins for invested assets:			
Agents notes receivable	63,875	63,875	
Investment income due and accrued	517,446		517,446
Premiums and considerations:			
Uncollected premiums and agents' balances in course of collection	225,316	580	224,736
Deferred premiums, agents' balances, and installments booked but deferred and not yet due	4,806,071		4,806,071
Reinsurance:			
Amounts recoverable from reinsurers	146,707		146,707
Current federal and foreign income tax recoverable and interest thereon	339,981		339,981
Net deferred tax asset	1,285,200		1,285,200
Electronic data processing equipment and software	529,823		529,823
Furniture and equipment, including health care delivery assets	265,085	265,085	
Write-ins for other than invested assets:			
Miscellaneous	30,242		30,242
Total Assets	$57,560,387	$329,540	$57,230,847

Germantown Mutual Insurance Company
Liabilities, Surplus, and Other Funds
As of December 31, 2004

Losses		$ 9,363,268
Reinsurance payable on paid loss and loss adjustment expenses		
Loss adjustment expenses		1,506,065
Commissions payable, contingent commissions, and other similar charges		1,150,981
Other expenses (excluding taxes, licenses, and fees)		2,047,474
Taxes, licenses, and fees (excluding federal and foreign income taxes)		10,662
Unearned premiums		15,928,862
Advance premium		621,031
Ceded reinsurance premiums payable (net of ceding commissions)		317,047
Remittances and items not allocated		61,408
Total Liabilities		31,006,798
Write-ins for special surplus funds:		
Non-assignable assessable guaranty fund	$ 437,500	
Unassigned funds (surplus)	25,786,549	
Surplus as Regards Policyholders		26,224,049
Total Liabilities and Surplus		$57,230,847

Germantown Mutual Insurance Company
Summary of Operations
For the Year 2004

Underwriting Income		
Premiums earned		$31,011,300
Deductions:		
Losses incurred	$14,622,505	
Loss expenses incurred	2,404,220	
Other underwriting expenses incurred	10,104,478	
Total underwriting deductions		27,131,203
Net underwriting gain or (loss)		3,880,097
Investment Income		
Net investment income earned	1,140,504	
Net realized capital gains or (losses)	158,566	
Net investment gain or (loss)		1,299,070
Other Income		
Net gain or (loss) from agents' or premium balances charged off	(43,581)	
Finance and service charges not included in premiums	113,413	
Write-ins for miscellaneous income:		
Gains from sales of assets	35,464	
Miscellaneous income	2,187	
Total other income		107,483
Net income (loss) after dividends to policyholders but before federal and foreign income taxes		5,286,650
Federal and foreign income taxes incurred		1,734,000
Net Income		$ 3,552,650

Germantown Mutual Insurance Company
Cash Flow
For the Year 2004

Premiums collected net of reinsurance			$31,919,601
Net investment income			1,167,268
Miscellaneous income			107,483
Total			33,194,352
Benefit- and loss-related payments		$13,160,301	
Commissions, expenses paid, and aggregate write-ins for deductions		11,722,042	
Federal and foreign income taxes paid (recovered)		2,180,641	
Total deductions			27,062,984
Net cash from operations			6,131,368
Proceeds from investments sold, matured, or repaid:			
Bonds	$16,327,849		
Stocks	16,314,278		
Mortgage loans	11,084		
Miscellaneous proceeds	63,293		
Total investment proceeds		32,716,504	
Cost of investments acquired (long-term only):			
Bonds	23,716,522		
Stocks	15,189,119		
Miscellaneous applications	147,117		
Total investments acquired		38,982,758	
Net cash from investments			(6,266,254)
Cash from financing and miscellaneous sources:			
Other cash provided (applied)		284,928	
Net cash from financing and miscellaneous sources			284,928
Reconciliation			
Net change in cash and short-term investments			150,042
Cash and short-term investments, December 31, 2003			527,247
Cash and short-term investments, December 31, 2004			$ 677,289

Germantown Mutual Insurance Company
Compulsory and Security Surplus Calculation
December 31, 2004

Assets		$57,230,847
Less liabilities		11,241,684
Adjusted surplus		26,224,049
Annual premium:		
Lines other than accident and health	$32,591,254	
Factor	20%	
Compulsory surplus (subject to a minimum of $2 million)		6,518,250
Compulsory surplus excess (or deficit)		$19,705,799
Adjusted surplus (from above)		$26,224,049
Security surplus: (140% of compulsory surplus, factor reduced 1% for each $33 million in premium written in excess of $10 million, with a minimum factor of 110%)		9,125,550
Security surplus excess (or deficit)		$17,098,499

Germantown Mutual Insurance Company
Reconciliation and Analysis of Surplus
For the Five-Year Period Ending December 31, 2004

The following schedule is a reconciliation of total surplus during the period under examination as reported by the company in its filed annual statements:

	2004	**2003**	**2002**	**2001**	**2000**
Surplus, beginning of year	$22,460,554	$19,521,955	$19,382,746	$19,327,003	$19,226,923
Net income	3,552,650	1,848,374	836,249	(202,468)	764,471
Net unrealized capital gains or (losses)	83,361	929,984	(835,657)	(473,347)	(672,015)
Change in net deferred income tax	104,900	277,700	160,401	567,400	
Change in nonadmitted assets	22,585	(117,460)	(21,784)	(10,642)	7,624
Cumulative effect of changes in accounting principles				174,800	
Surplus, end of year	$26,224,049	$22,460,554	$19,521,955	$19,382,746	$19,327,003

Germantown Mutual Insurance Company
Insurance Regulatory Information System
For the Five-Year Period Ending December 31, 2004

The company's NAIC Insurance Regulatory Information System (IRIS) results for the period under examination are summarized below. Unusual IRIS results are denoted with asterisks and discussed below the table.

	Ratio	2004	2003	2002	2001	2000
#1	Gross Premium to Surplus	144.0%	152.0%	138.0%	103.0%	89.0%
#2	Net Premium to Surplus	124.0	132.0	110.0	78.0	62.0
#3	Change in Net Writings	10.0	39.0*	41.0*	28.0	14.0
#4	Surplus Aid to Surplus	0.0	0.0	0.0	1.0	1.0
#5	Two-Year Overall Operating Ratio	83.0	86.0	94.0	98.0	90.0
#6	Investment Yield	2.5*	2.9*	2.3*	2.5*	3.2*
#7	Change in Surplus	17.0	18.0	5.0	2.0	0.0
#8	Liabilities to Liquid Assets	56.0	56.0	52.0	49.0	43.0
#9	Agents' Balances to Surplus	1.0	0.0	0.0	1.0	3.0
#10	One-Year Reserve Development to Surplus	-2.0	0.0	-2.0	-1.0	-4.0
#11	Two-Year Reserve Development to Surplus	-1.0	-2.0	-2.0	-3.0	-6.0
#12	Estimated Current Reserve Deficiency to Surplus	-3.0	2.0	2.0	-4.0	-4.0

* Indicates an unusual value

Ratio No. 3 reflects the percentage change in net premiums written from the prior year. The exceptional results in 2002 and 2003 were due primarily to rate increases. In 2002 the company also expanded to Utah and began writing worker's compensation policies which increased the company's commercial line products.

Ratio No. 6 is net investment income earned as a percentage of the average amount of cash and invested assets during the year. The low results in all the years under examination can be attributed to the fact that the company has a majority of its fixed income securities invested in tax-exempt bonds, which typically produce a lower investment yield.

Growth of Germantown Mutual Insurance Company

Year	Admitted Assets	Liabilities	Surplus As Regards Policyholders	Net Income
2004	$57,230,847	$31,006,798	$26,224,049	$3,552,650
2003	49,217,998	26,757,444	22,460,554	1,848,374
2002	39,326,030	19,804,075	19,521,955	836,249
2001	35,332,112	15,949,366	19,382,746	(202,468)
2000	31,610,781	12,283,778	19,327,003	764,471
1999	30,468,607	11,241,684	19,226,923	960,097

Year	Gross Premium Written	Net Premium Written	Premium Earned	Loss and LAE Ratio	Expense Ratio	Combined Ratio
2004	$37,862,968	$32,591,254	$31,011,300	54.9%	30.7%	85.6%
2003	34,120,525	29,679,729	26,384,812	58.9	29.2	88.1
2002	27,006,795	21,387,009	18,349,501	63.4	28.7	92.1
2001	20,054,341	15,180,571	13,414,401	80.9	27.5	108.4
2000	17,115,683	11,887,733	11,206,916	72.3	28.1	100.4
1999	15,309,024	10,450,383	10,120,926	62.2	32.9	95.1

As noted above, the company is well capitalized. For the period under examination, the company reported net income in all the years except when the company was impacted by severe weather-related losses in 2001. Surplus increased 36% since the last examination to $26.2 million.

Gross premium written increased 147% over the last five years. Prior to 2002, the company was geographically focused in the Midwest. As mentioned earlier, the company expanded to Utah to reduce its geographical concentration of property risks. Since then 22% of the company's premium growth is attributable to business in Utah.

Reconciliation of Surplus per Examination

There were no adjustments or reclassifications made to surplus as a result of the examination. The amount of surplus reported by the company as of December 31, 2004, is accepted.

VI. SUMMARY OF EXAMINATION RESULTS

Compliance with Prior Examination Report Recommendations

There were nine specific comments and recommendations in the previous examination report. Comments and recommendations contained in the last examination report and actions taken by the company are as follows:

1. Affiliated Agreements—It is recommended that the company develop and execute intercompany service/cost-sharing/income-tax agreements and submit such agreements to this office for review in compliance with s. 617.21, Wis. Stat., and s. Ins 40.02 (d), Wis. Adm. Code.

   Action—Not Applicable. The company no longer has any affiliates.

2. Holding Company Transactions—It is recommended that Form B and Form C shall be filed with this office within 90 days of the adoption of this report and annually by June 1 on all subsequent years, pursuant to s. Ins 40.03 (2), Wis. Adm. Code.

   Action—Not Applicable. The company no longer has any affiliates

3. Holding Company Transactions—It is recommended that the NAIC Annual Statement Instructions for Property and Casualty Insurers be followed for reporting subsidiary transactions on the annual statement.

   Action—Not Applicable. The company no longer has any affiliates.

4. Accounts and Records—It is suggested that the company develop a procedure to more easily recapture year-end data.

   Action—Compliance.

5. Deferred Premiums—It is recommended that the company separate deferred premiums from the in course of collection as stated in the NAIC Annual Statement Instructions for Property and Casualty Insurers on all future annual statements.

   Action—Compliance.

6. Advance Premium—It is recommended that the company report advance premium on premium received instead of reporting all billed in advance as a liability. It is further recommended that the company also adjust agents' balances down by the amount that is billed in advance according to the NAIC Annual Statement Instructions for Property and Casualty Insurers.

   Action—Noncompliance; see comments in the section of this report captioned “Summary of Current Examination Results.”

7. Data Center and Operations—It is recommended that the company should keep the outer door by the hall locked and access to the data center be controlled and monitored by a sign-in sheet.

   Action—Compliance.

8. Data Center and Operations—It is recommended that the company should move printers used by nonoperations personnel to an area outside the data center to eliminate the need for entry into the data center to retrieve printed items.

   Action—Compliance.

9. Data Center and Operations—It is recommended that the company should provide a “waterproof” and “fireproof” box for the storage of the mainframe back-up tapes.

   Action—Compliance.

Summary of Current Examination Results

This section contains comments and elaborations on those areas where adverse findings were noted or where unusual situations existed. Comments on the remaining areas of the company's operations are contained in the examination work papers.

Board of Directors

In the review of the board minutes for the period under examination and subsequent periods up to the date of the examination, it was noted that for all the years under examination Richard Smith, President, has been elected as a member of the Compensation Committee. This committee recommends officer salaries for the preceding year, including the salary of the president. At the end of the year, the board votes on the recommendations of the Compensation Committee; however, the minutes do not indicate that the president abstains from voting on matters affecting his interest. It is recommended that directors with conflict of interest properly abstain from voting on matters affecting their interest and that the minutes clearly indicate it pursuant to s. 611.60, Wis. Stat.

Electronic Data Processing Software

In 2004, as a result of a company-wide reorganization, the company purchased a new property and casualty information processing system and a paperless workflow system. In review of the company’s systems, it was noted that the two systems were erroneously classified as operating software. These systems should have been classified as nonoperating systems and nonadmitted in accordance with SSAP No. 16, paragraph 2. The amount determined was below tolerable error and no adjustment to surplus was made as a result of the examination. It is recommended that the company nonadmit nonoperating system software in accordance with SSAP No. 16, paragraph 2.

Reinsurance Intermediary Broker

The company utilizes a reinsurance intermediary broker to place reinsurance cession on behalf of the company. The company has adequate contracts in place with its reinsurance intermediary broker; however, it was determined that the company does not conduct annual review of the financial condition of its reinsurance intermediary broker nor do they ensure the broker has a valid license pursuant to the duties of insurers under s. Ins 47.05, Wis. Adm. Code. It is recommended that the company conduct an annual review of the financial condition of its intermediary broker, including obtaining copies of financial statements and determining that the intermediary broker has obtained a valid license in accordance with s. Ins 47.03, Wis. Adm. Code.

Agent Incentive Program

The company owns two condominiums, one in Door County, Wisconsin, and the other in Fort Meyers Beach, Florida. The condominiums are used solely for a point-based agent incentive program. Agents earn points for new businesses acquired during a qualifying period and the points can be used toward stays at either condo for a specific period. At the end of the year, the usage of the condo is included on agents' IRS Form 1099; based on the estimated market value of the condo at the time of use. In 2004 the total amount of compensation reported on agents' IRS Form 1099 relating to the incentive program was $35,632.

Other Invested Assets

On July 29, 2002, the company purchased 5.71% ownership interest in a limited liability company (the LLC). In the review of the company's ownership it was noted that the company calculated its investment ownership in the LLC as the initial investment less capital distributions. Pursuant to SSAP No. 48, paragraph 6-8, investment in a limited liability company with minority interest should be recorded based on the underlying audited U.S. GAAP equity of the LLC. It was determined that the company does not receive audited GAAP financial statements from the LLC. Since the company does not receive audited GAAP financial statements from the LLC, nor do they own enough interest in the LLC to require an audited GAAP financial statement, the company's investment in the LLC should be nonadmitted. The company's investment in the LLC at year-end was considered to be below tolerable error; therefore, no adjustment to surplus was made as a result of the examination. It is recommended that the company record investments in limited liability companies in accordance with SSAP No. 48.

Advance Premiums

The prior examination noted that the company's advance premium balance included premiums billed in advance on policies becoming effective in the subsequent year, for which cash has not been received. The current examination noted that the advance premium balance included only policies with effective dates in the subsequent year; including some policies for which cash has been received and some policies for which no cash has been received. Pursuant to SSAP No. 53, paragraph 15, advance premium is cash received prior to the effective date of the policy. The company believed that this was a system failure. As mentioned earlier under "Electronic Data Processing Software," the company purchased a new information processing system in 2005 as part of a company-wide reorganization. The company indicated that this new system should be able to report advance premium accurately. However, it is again recommended that the company report advance premium in accordance with SSAP No. 53, paragraph 15.

Deferred Premiums

The examination's review of deferred premiums noted that the balance for "Deferred premiums, agents' balances and installments booked but deferred and not yet due" (Annual Statement Page 2, Line 12.2) consists of all premium receivables, offset by premium receivables for December renewal policies in their grace period. These renewal policies represent policies that have lapsed but are still within the company's grace period before cancellation. Testing of deferred premium determined that the original data used to calculate gross deferred premium did not include these "grace period" policies; therefore, these renewal policies should not have been offset against premium receivable. Conversely, it was determined that the data used by the company to calculate gross deferred premium included premium receivables on policies effective in 2005 (which should not be recorded as an asset at year-end 2004) and current premiums due and not yet collected. To calculate deferred premium accurately, the company should have subtracted the premium receivable for policies effective in 2005 and premiums due and not yet collected. The premiums that were due and not yet collected should be reported as "Uncollected premiums and agents' balance in the course of collection" (Annual Statement Page 2, Line 12.1) in accordance with the NAIC Property/Casualty Quarterly and Annual Statement Instructions. The net difference was determined to be immaterial; therefore, no reclassification or adjustment to surplus was made as a result of the examination. The company is recommended to report all premiums due and uncollected as “Uncollected premiums and agents’ balance in the course of collection” and all premiums receivable billed but not yet due as “Deferred premiums, agents’ balances and installments booked but deferred and not yet due” in accordance with NAIC Property/Casualty Quarterly and Annual Statement Instructions.

In addition, the prior examination also noted that the company included premium receivable for policies effective in the subsequent year as deferred premium. It is again recommended that the company exclude premium receivable on premiums billed in advance for policies effective in the subsequent year from “Deferred premiums, agents’ balances and installments booked but deferred and not yet due” in accordance with the NAIC Property/Casualty Quarterly and Annual Statement Instructions.

Premiums In the Course of Collection

In 2005 the company amended its annual statement to include the billed installment amount for premium receivables for December renewal policies on “Uncollected premiums and agents’ balance in the course of collection.” As mentioned above under “Deferred Premium,” these renewal policies are policies that have lapsed but are still within the grace period before cancellation. Testing of the renewal policies determined that these policies were not in the in-force file at year-end. Furthermore, a corresponding unearned premium reserve was not established at year-end for these policies. The company indicated that written premium is recognized in the system when initial cash has been received; therefore, unearned premium reserve is not established until written premium has been recorded. The company also indicated that this was the first time the company amended its financial statement to include premium receivable on renewal policies.

Recording the installment premium receivable on renewal policies as an asset, without establishing a corresponding unearned premium reserve, violates the established statutory accounting principles for recording and recognition of premium revenue consistent with the Statutory Accounting Principles Statement of Concepts and Statement of Concepts. To report installment premium receivable on renewal policies accurately, the company should report written premium for these policies and establish a corresponding unearned premium reserve or eliminate the premium receivable on renewal policies entirely. The balance reported at year-end was determined to be below tolerable error; therefore, no adjustment to surplus was made as a result of the examination. However, it is recommended that the company's accounting method used to report all premium balances is consistent with the statutory accounting principles for recording and recognition of premium revenue, including properly reporting premium receivable on renewal policies.

Bonds

In the review of bonds, it was determined that security designations reported in the Annual Statement Schedule D – Part 1 were not complete. Sample testing determined that the numerical designations reported on Schedule D – Part 1 were accurate; however, should have been followed by an "FE" (Filing Exempt) in accordance with the Purposes and Procedures Manual of the NAIC Securities Valuation Office.

In addition, it was determined that the company did not properly complete Schedule D – Part 1, Column 5, by failing to indicate the characteristic of its bonds, particularly callable bonds, as required by the NAIC Property/Casualty Quarterly and Annual Statement Instructions. In a sample testing on bond amortization value, the examination noted significant differences with a majority of the bonds tested. It was discovered that these bonds were callable bonds and the differences were that callable bonds are amortized to the call date and not the maturity date. Once callable bonds were identified, the amortization method used by the company was determined accurate.

It is recommended that the company properly complete Schedule D – Part 1 on all future financial statements in accordance with the NAIC Property/Casualty Quarterly and Annual Statement Instructions and the Purposes and Procedures Manual of the NAIC Securities Valuation Office.

Loss and LAE Reserves

The independent actuary hired by this office determined that the company's reserves were adequate and no adjustments were necessary. However, the independent actuary determined that in the Statements of Actuarial Opinions the appointed actuary did not explicitly identify in the opinion paragraph which category applies to the opinion, as specified in the Actuarial Opinion instruction, paragraph 5, sections (a) through (e), of the NAIC Property/Casualty Quarterly and Annual Statement Instructions. [A 5(a) opinion means a determination of reasonable provision, 5(b) means a determination of deficient or inadequate provision, 5(c) means a determination of redundant or excess provision, 5(d) means a qualified opinion, and 5(e) means no opinion.] It is recommended that the Statements of Actuarial Opinion include an explicit identification of which category applies to the opinion paragraph as required in the Actuarial Opinion instructions, paragraph 5, in the NAIC Property/Casualty Quarterly and Annual Statement Instructions.

VII. CONCLUSION

The current examination finds that the company is adequately capitalized. For the period under examination, the company reported net income in all the years except when the company was impacted by severe weather-related losses in 2001. Since the prior examination assets increased 88% to $57,230,847, premium increased 148% to $37,780,565 and surplus increased 36% to $26,224,049.

The company has complied with seven of the eight previous recommendations. The current examination resulted in ten recommendations pertaining to the board minutes, electronic data processing software, reinsurance intermediary, advance premium, premium receivables, bonds, and loss reserves.

VIII. SUMMARY OF COMMENTS AND RECOMMENDATIONS

1. Page 25 - Board of Directors—It is recommended that directors with conflict of interest properly abstain from voting on matters affecting their interest and that the minutes clearly indicate it pursuant to s. 611.60, Wis. Stat.

2. Page 25 - Electronic Data Processing Software—It is recommended that the company nonadmit nonoperating systems software in accordance with SSAP No. 16, paragraph 2.

3. Page 26 - Reinsurance Intermediary Broker—It is recommended that the company conduct an annual review of the financial condition of its intermediary broker, including obtaining copies of financial statements and determining that the intermediary broker has obtained a valid license in accordance with s. Ins 47.03, Wis. Adm. Code.

4. Page 26 - Other Invested Assets—It is recommended that the company record investments in limited liability companies in accordance with SSAP No. 48.

5. Page 27 - Advance Premiums—However, it is again recommended that the company report advance premium in accordance with SSAP No. 53, paragraph 15.

6. Page 28 - Deferred Premiums—The company is recommended to report all premiums due and uncollected as “Uncollected premiums and agents’ balance in the course of collection“ and all premiums receivable billed but not yet due as “Deferred premiums, agents’ balances and installments booked but deferred and not yet due” in accordance with NAIC Property/Casualty Quarterly and Annual Statement Instructions.

7. Page 28 - Deferred Premiums—It is again recommended that the company exclude premium receivable on premiums billed in advance for policies effective in the subsequent year from “Deferred premiums, agents’ balances and installments booked but deferred and not yet due” in accordance with the NAIC Property/Casualty Quarterly and Annual Statement Instructions.

8. Page 29 - Premiums In the Course of Collection—However, it is recommended that the company’s accounting method used to report all premium balances is consistent with the statutory accounting principles for recording and recognition of premium revenue, including properly reporting premium receivable on renewal policies.

9. Page 29 - Bonds—It is recommended that the company properly complete Schedule D – Part 1 on all future financial statements in accordance with the NAIC Property/Casualty Quarterly and Annual Statement Instructions and the Purposes and Procedures Manual of the NAIC Securities Valuation Office.

10. Page 30 - Loss and LAE Reserves—It is recommended that the Statements of Actuarial Opinion include an explicit identification of which category applies to the opinion paragraph as required in the Actuarial Opinion instructions, paragraph 5, in the NAIC Property/Casualty Quarterly and Annual Statement Instructions.

IX. ACKNOWLEDGMENT

The courtesy and cooperation extended during the course of the examination by Les Ibach and employees of the company are acknowledged.

In addition to the undersigned, the following representatives of the Office of the Commissioner of Insurance, State of Wisconsin, participated in the examination:

Name	Title
Elena Vetrina	Financial Examiner
Tim VandeHey	Financial Examiner – Advanced
Jerry DeArmond	Financial Examiner – Advanced
Fred Thornton	Financial Examiner – Advanced

Respectfully submitted,

Sheur Yang
Examiner-in-Charge